



TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

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Contact Person:

Identification Number:

Telephone Number:

Employer Identification Number:

Uniform Issue List:

512.00-00

Legend:

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G =
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Dear :

This is in response to G's request for a ruling that certain proposed contractual relationships will not generate unrelated business taxable income under section 512(a)(1) of the Internal Revenue Code (the "Code").

E is exempt under section 501(a) of the Code as an organization described in section 501(c)(3) and has been classified as an educational organization under sections 509(a)(1) and 170(b)(1)(A)(ii). E has structurally and financially controlled colleges and schools and controlled charitable arms, identified above as H - X (referred to hereafter as "E and its controlled entities"). H through X are all exempt under section 501(c)(3) and are not private foundations.

E is the trustee of a number of charitable remainder trusts (collectively, "the Trusts"), and as trustee, E is the owner of the Trusts' assets. E and its controlled entities have the sole remainder interest in each of the Trusts. G is one such charitable remainder trust in which E is trustee and remainder beneficiary.

P manages the endowment and other long term investments for E and its controlled entities as well as for all trusts for which E serves as trustee. P assesses an administrative charge against trust assets, which is calculated to offset direct management costs and is generally paid by each charitable remainder trust on a quarterly basis.

As a result of the relationship with the Trusts as both trustee and remainder beneficiary, E and its controlled entities have a substantial interest in the value of each Trust. Moreover, the donors to the Trusts have funded the Trusts with the intention that E and its controlled entities benefit substantially from the assets of the Trusts, and that the assets will be managed to achieve the greatest possible return on investment.

E's endowment is invested in traditionally publicly traded assets and private investments. E's private investments include real estate and certain other venture investments undertaken primarily through partnership structures. Much of the income earned by the portfolio consists of passive dividends, interest, rents, and long and short-term capital gains, but some income is debt-financed or otherwise treated as unrelated business taxable income.

E proposes to create a contractual obligation, pursuant to which it, working through P, would issue a contract right for a proportionate share of E's endowment. The cumulative value of the shares would be the dollar value of the assets held by the individual Trusts combined with the shares of the endowment held by the various restricted and unrestricted funds of E's institution. The contract right would entitle the Trusts to receive periodic payments based on the shares owned by each of the Trusts. The Trusts would thereby be able to receive an investment return equal to that of the endowment.

E determines a spending rate on the endowment each year based in part on the endowment's investment performance. E calculates the market value of each endowment share on a monthly basis based on the underlying asset value of the endowment. Each restricted or unrestricted fund is entitled to a payment in an amount equal to the spending rate times the number of shares it holds.

E seeks to enable the Trusts to invest in the endowment in a manner similar to its restricted and unrestricted funds. A Trust would acquire a share in the endowment which would give the Trusts a contractual right against the University, but no interest whatsoever in the underlying investment assets of the endowment. The shares would have the same value that E uses for internal accounting purposes.

The contract would provide that each Trust would receive payments on the shares held by it equal to the spending rate E establishes for the endowment, with payouts made at least annually or more frequently as appropriate. A Trust could choose either to reinvest part of the payout, or redeem additional

shares, depending on its cash requirements. The Trusts will treat payouts, up to the spending rate, as ordinary income, regardless of the character of the underlying income of the endowment, whether capital gain, ordinary income, or return of capital, and regardless of whether the payout is made entirely by distributions of income or in part by redemption of shares. The Trusts will treat redemptions of shares (over and above receipt of the spending rate) as generating long- or short-term capital gain (or loss), depending on the holding period of the redeemed shares.

Under the contract, the Trusts would not have any ownership interest in the underlying assets of the endowment or any contract rights with respect to the other trusts. The Trusts would have no power or right of any kind to control, direct, supervise, recommend or review E's business activities, operations, or decisions with respect to the endowment, except the right to review the payout computations. They would not have the right to veto or opt out of any of the underlying endowment investments. The contract would provide that, with respect to the issuance of shares, E is neither a partner nor an agent of the Trusts; that the Trusts would never be or become liable for any cost, expense, or payment incurred or due by E or for which E is liable or responsible relating to the endowment (or the underlying endowment assets), and, consistent with E's status as a fiduciary, E will not allow the Trusts to suffer any liability arising out of any action or inaction by E with respect to the endowment (or the underlying endowment assets).

As stated above, E's investments are managed by one of its tax-exempt controlled entities, P. Investment managers typically charge a fee and receive reimbursement of expenses in the process of managing the endowment. P assesses an administrative charge against endowment assets, as it will against trust assets, to offset direct management costs. These fees and expenses directly or indirectly reduce E's total return on its endowment. Consequently, those fees will be reflected indirectly in the spending rate payments to be made to the Trusts.

In a letter dated April 11, 2007, E represented that it places representatives on the respective boards of directors of each controlled entity and E "controls" each such entity. Each of the named controlled entities has a purpose that is functionally related to E's educational purpose.

You have requested the following ruling:

The issuance of shares by E to the Trusts, the making or receipt of payments with respect to the shares, and the holding or redemption of the shares, will not generate unrelated business taxable income to G.

LAW

Section 511 of the Code, in part, imposes a tax on the unrelated business taxable income of organizations described in section 501(c)(3).

Section 512(a)(1) of the Code defines the term "unrelated business taxable income" as the gross income derived by any organization from any unrelated trade or business regularly carried on by it, less the allowable deductions which are directly connected with the carrying on of such trade or business, both computed with the modifications provided in section 512(b).

Section 512(b) of the Code sets forth so-called "modifications," which are excluded from the computation of unrelated business taxable income. These modifications include dividends, interest, royalties, rent from real property, and gain from the sale of property.

Section 513(a) of the Code defines the term "unrelated trade or business" as any trade or business the conduct of which is not substantially related (aside from the need of such organization for

income or funds or the use it makes of the profits derived) to the exercise or performance by such organization of its exempt purpose or function.

Section 513(c) of the Code provides that the term "trade or business" includes any activity, which is carried on for the production of income from the sale of goods or the performance of services.

Section 1.513-1(a) of the Income Tax Regulations provides that gross income of an exempt organization subject to the tax imposed by section 511 of the Code is includible in the computation of unrelated business taxable income if: (1) it is income from a trade or business; (2) such trade or business is regularly carried on by the organization; and (3) the conduct of such trade or business is not substantially related (other than through the production of funds) to the organization's performance of its exempt functions.

Section 1.513-1(b) of the regulations provides that for purposes of section 513 of the Code the term "trade or business" has the same meaning it has in section 162 and generally includes any activity carried on for the production of income from the sale of goods or performance of services.

Section 1.513-1(c)(1) of the regulations provides that in determining whether trade or business from which a particular amount of gross income derives is "regularly carried on," within the meaning of section 512 of the Code, regard must be had to the frequency and continuity with which the activities productive of the income are conducted and the manner in which they are pursued. For example, specific business activities of an exempt organization will ordinarily be deemed to be "regularly carried on" if they manifest a frequency and continuity, and are pursued in a manner generally similar to comparable commercial activities of non-exempt organizations.

Section 1.513-1(d)(1) of the regulations provides that, in general, gross income derives from "unrelated trade or business," within the meaning of section 513(a) of the Code, if the conduct of the trade or business which produces the income is not substantially related (other than through the production of funds) to the purposes for which exemption is granted. The presence of this requirement necessitates an examination of the relationship between the business activities which generate the particular income in question -- the activities, that is, of producing or distributing the goods or performing the services involved -- and the accomplishment of the organization's exempt purposes.

Section 1.513-1(d)(2) of the regulations provides that trade or business is "related" to exempt purposes, in the relevant sense, only where the conduct of the business activities has a causal relationship to the achievement of exempt purposes, and is "substantially related," for purposes of section 513 of the Code, only if the causal relationship is a substantial one. Thus, for the conduct of trade or business from which a particular amount of gross income is derived to be substantially related to purposes for which exemption is granted, the production or distribution of the goods or the performance of the services from which the gross income is derived must contribute importantly to the accomplishment of those purposes. Where the production or distribution of the goods or the performance of the services does not contribute importantly to the accomplishment of the exempt purposes of an organization, the income from the sale of the goods or the performance of the services does not derive from the conduct of related trade or business. Whether activities productive of gross income contribute importantly to the accomplishment of any purpose for which an organization is granted exemption depends in each case upon the facts and circumstances involved.

Rev. Rul. 69-528, 1969-2 C.B. 127, describes an organization that was formed to provide investment services on a fee basis exclusively to organizations exempt under section 501(c)(3) of the Code. It receives funds from the participating exempt organizations, invests in common stocks, reinvests income and realized appreciation, and upon request liquidates a participant's interest and distributes the

proceeds to the participant. The Rev. Rul. states that providing investment services on a regular basis for a fee is a trade or business ordinarily carried on for profit. If the services were regularly provided by one tax-exempt organization for other tax-exempt organizations, such activity would constitute unrelated trade or business. The Rev. Rul. holds that the organization is not exempt under section 501(c)(3).

As noted previously, organizations described in section 501(c)(3) of the Code are subject to tax on their unrelated business income under section 511. In order for such an organization's income to be subject to the unrelated business income tax, three requirements must be met: (1) the income must be from a trade or business; (2) the trade or business must be regularly carried on; and (3) the conduct of the trade or business must not be substantially related to the organization's exempt purpose or function. See section 1.513-1(a) of the regulations.

ANALYSIS

E proposes to enter into a contractual relationship with certain Trusts that are charitable remainder trusts in which E and the controlled entities have a beneficial interest and E serves as trustee of the Trust. Under such a contractual relationship, each Trust would receive payments on the shares held by it equal to the spending rate E establishes for its endowment, with payouts made as determined by E.

Each Trust would acquire shares from the endowment, which would give the Trusts a contractual right against E, but no interest whatsoever in the underlying investment assets of the endowment. The contract between E and the Trusts would provide that the price of the shares would equal their value at the time of acquisition. The shares would have the same value that E uses for internal accounting purposes.

Consequently, a Trust could choose either to reinvest part of the payout, or redeem a portion of the shares, depending on its cash requirements. Thus, under the contractual relationship with E, the Trusts would have a right to the payout declared by E plus the right to redeem the shares at the value that E uses for internal accounting purposes.

Generally, an organization that otherwise qualifies for recognition of exemption under section 501(c)(3) of the Code and provides investment services on a regular basis for a fee to other exempt or nonexempt organizations would be engaged in an unrelated trade or business under section 513(a). See Rev. Rul. 69-528, supra. Such an activity would constitute a "trade or business" under sections 513(c) and 1.513-1(b) of the regulations, and would be "regularly carried on" under sections 512(a)(1) and 1.513-1(c). Thus, if E charged a fee for investment management services provided to organizations unrelated to E or generated income from the management of the funds invested by such organizations, these activities could result in unrelated business taxable income under section 512(a)(1). Here, however, E, working through P, recovers an amount sufficient to offset the actual cost of management of the endowment, including management of the Trusts but is not charging a fee for its services. E does not otherwise receive income from the services provided to the Trusts. Thus, under these circumstances, E will not receive unrelated business taxable income under section 512(a)(1).

The fact that E, working through P, will engage in the investment activity for the benefit of individuals who are co-beneficiaries of the Trusts at the same time that it engages in investment activity for its own benefit and the controlled entities as the remainder beneficiary or beneficiaries limits the scope of the service provided to "others" and distinguishes it from a commercial venture.

As stated above, under the contract, the Trusts would not have any ownership interest in the underlying assets of the endowment nor any contract rights with respect to the other trusts. The Trusts

would have no power or right of any kind to control, direct, supervise, recommend or review F's business activities, operations, or decisions with respect to the endowment, except the right to review the payout computations. They would not have any right to veto or opt out of any of the underlying endowment investments. The contract would provide that, with respect to the issuance of shares, F is neither a partner nor an agent of the Trusts; that the Trusts would never be or become liable for any cost, expense, or payment incurred or due by F or for which F is liable or responsible relating to the endowment (or the underlying endowment assets), and, consistent with F's status as a fiduciary, F will not allow the Trusts to suffer any liability arising out of any action or inaction by F with respect to the endowment (or the underlying endowment assets).

The Trusts do not have a position of ownership in the underlying assets of F's endowment. Since the contractual relationship between F and the Trusts is not in the nature of a partnership or agency, the income earned by the Trusts from the payout F establishes for the endowment reflects ordinary income and does not take on the character of the income of the underlying assets or debt-financed or unrelated business taxable income. F would pay any tax owed on UBTI earned by the endowment portfolio, with no deduction taken against UBTI for any payments made to the Trusts.

In view of the foregoing, and based on your representations, we rule as follows:

The issuance of Units from F to the Trusts, the making or receipt of payments with respect to the Units, and the holding or redemption of the Units, will not generate unrelated business taxable income to G.

This ruling is based on the understanding that there will be no material changes in the facts upon which it is based.

We express no opinion as to the tax consequences of the proposed transaction under any other section of the Code.

Pursuant to a Power of Attorney on file in this office, a copy of this letter is being sent to your authorized representatives. A copy of this letter should be kept in your permanent records.

This ruling is directed only to the organization that requested it. Section 6110(k)(3) of the Code provides that it may not be used or cited by others as precedent.

If there are any questions about this ruling, please contact the person whose name and telephone number are shown in the heading of this letter.

Sincerely,

Robert C. Harper, Jr.
Manager, Exempt Organizations
Technical Group 3

Enclosure
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